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SIPDIS

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SUBJECT: ISRAELI ECONOMIC GROWTH SLOWS IN THIRD QUARTER

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1. (SBU) Summary. Although the economy slowed in the third quarter, it will grow close to 4% for the year as a whole. The deficit is likely to come in under the targeted level of 4% as a result of the GOI's lid on spending and a positive revenue picture. The Bank of Israel (BOI) took advantage of a low-inflation environment to cut interest rates 0.2% in November, providing monetary policy support for continued economic expansion in 2005.

2. (SBU) Growth has yet to result in a significant reduction in unemployment, which remains at 10.2% as of the third quarter. The picture is unlikely to improve in 2005. The poor unemployment numbers increased the political impact of the "poverty report," issued annually in November by the National Insurance Institute, which claimed that almost 30% of all Israeli children live under the poverty line.

3. (SBU) Economic stability has not been affected by Likud's ongoing efforts to form a coalition with Labor as well as with at least one religious party. Within the context of the coalition negotiations, economic commentators believe Labor will use the poverty report to push for changes to the GOI's economic program, including possible delays in implementing the Bachar Committee's capital market reforms, approved by the Government on November 14. Finance Ministry officials claim Labor's participation will have only a minimal impact on the budget, which is likely to be submitted quickly to the Knesset once the new coalition is in place. Although the GOI continues to move towards Gaza disengagement, it has yet to finalize budgetary numbers. End Summary

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Third Quarter Growth Slows  
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4. (U) Although the Israeli economy continued to expand in the third quarter, it did so at a significantly slower pace than earlier in the year. This was due to a contraction in personal consumption, the port strike of July-August, which restricted both imports and exports; and a decline in international demand for Israeli exports.

5. (U) According to initial Central Bureau of Statistics figures based on partial statistics, the economy grew by 3.7% on an annualized basis in the third quarter, following annualized growth of 4.3% in each of the first two quarters. Private consumption expenditure, which had been showing signs of improvement earlier in the year, also contracted; in particular, consumption of durable goods per capita declined by 20% in the third quarter, following growth of 10.5% in the second quarter of 2004. Per capita private consumption declined by 1.8% in the third quarter, compared with an increase of 1.1% in the second quarter of 2004, and increases of 2.3% both in the first quarter of 2004 and the fourth quarter of 2003.

6. (U) Business sector GDP growth moderated to 3% in the third quarter from 6% in the second quarter. The third quarter was the first quarter since the third quarter of 2003 in which business sector GDP was lower than GDP. The slower growth in the business sector reflects the significant reduction in export growth from 23% in the first quarter, to 13% in the second quarter, and 4.2% in the third quarter. The lower export figures are due in large part to the port strikes during July and August. Imports of goods, also negatively affected by the port strike, grew by just 1.8% in the third quarter, compared with 12% in the second quarter and 24% in the first quarter. The main indication of investment, fixed capital formation, declined by 14.3% in the third quarter, compared with a decline of 3.2% in the previous quarter.

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CBS: Overall 2004 Growth Close to 4%  
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7. (SBU) On October 18, the Central Bureau of Statistics reported that their preliminary growth estimates indicated that growth would be 4% in 2004. A CBS contact told us this view obtained in spite of the decline in most major

components in the third quarter. He cited positive trend data, which indicated an increase in imports of raw materials, durable goods and consumer durables in October. Industrial production also showed a positive trend in each of the last three months.

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2004 Deficit Below Target  
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18. (U) GOI and other private forecasts indicate that the 2004 deficit will be in the 3% to 3.5% range. The cumulative deficit for the first eleven months of 2004 totaled NIS 11.4 billion, which is only 55% of the NIS 20.6 billion deficit target for the entire year. By comparison, the deficit for the first 11 months of 2003 stood at NIS 21.2 bio. A Bank Leumi economist told us that in his estimation the deficit will be somewhere between 3% to 3.5% for the year, as the government is likely to increase expenditures in December. The reduction in the deficit to less than 3.5% from a deficit of 5.6% of GDP is primarily a result of the GOI's success in curbing expenditures, as evidenced by cumulative expenditures for 11 months of NIS 175 bio, or NIS 46 billion less than the expenditure target of NIS 221 billion. Although there has been a slowing down in tax revenues in recent months, the GOI is likely to meet the tax target of the 2004 budget.

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BOI Reduces Rates by 0.2% in November  
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19. (U) On November 22, the Bank of Israel announced a 0.2% interest rate reduction to 3.9% from 4.1%. This was the first change in interest in seven months, since the BOI reduced rates by 0.2% at the end of March. In its press release, the BOI indicated that the reduction was based on the very low level of inflation in the past few months, as well as the assessment that inflation will be within the range of price stability (current inflation rate for the year is 1.2%). The Central Bank also cites the slower economic recovery and weaker dollar as reasons for lowering interest rates without concern that it would cause economic or financial instability.

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Unemployment High but Declining  
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10. (U) The Central Bureau of Statistics reported on November 24 that unemployment declined to 10.2% in the third quarter of 2004, from 10.5% in the second quarter. There was an increase of 3.3% in the number of employed persons in the first 9 months of 2004 compared with the comparable period in 2003, representing an increase of 76,000 people. After the release of the unemployment data, Finance Minister Netanyahu expressed satisfaction with the consistent and continuous decline in unemployment during the last year, and said that this supported the efficacy of the government's economic policies.

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Poverty Report Sparks Discussion on Bibinomics  
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11. (U) The publication of Bituach Leumi's (National Insurance Institute) poverty report in November led to an intensification of Israel's debate over combating poverty. Finance Ministry officials believe in using a range of economic incentives, including the reduction of transfer payments, to induce more people to enter the workforce. Other observers, including the Bank of Israel and Bituach Leumi (BL), believe the GOI has reduced government support to the poor and unemployed too far too fast, thereby unnecessarily increasing poverty levels.

12. (SBU) The report indicates that there was an 8% increase in the number of people living in poverty to more than 1.4 million people in 2003, an increase of more than 100 thousand compared with 1.3 million in 2002. The 2003 statistics indicated that 29.4% of children and 19% of families were living below the poverty level, even after receipt of transfer payments. In view of the proposed inclusion of the Labor party in the Government, it is likely that the poverty report and its findings will remain an important part of the economic debate in 2005.

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Bachar Capital Market Reforms Move Forward  
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13. (SBU) The Bachar capital market reform recommendations, which are intended to increase competition in the very centralized and concentrated banking sector, were approved by the Government on November 14. The main aspects of the reforms include removing Provident funds (private retirement funds) and mutual funds from the banks, ownership and

management over the next few years. In return, the banks will be able to enter the insurance market, and sell life insurance. The banking community has strong reservations about the reforms and is seeking to delay their implementation.

14. (SBU) Debate over the Bachar reforms is taking place against the background of increased bank bashing<sup>8</sup> resulting from perceptions these institutions have taken advantage of their strong position to leverage outsized customer fees. The reforms have also become something of a bargaining chip in coalition talks between the various parties. As one Central Bank official told us, it is impossible to predict whether the Bachar recommendations will have a fate any more successful than other (unimplemented) financial reform plans introduced over the past twenty years. She nonetheless finds them appropriate and necessary for reforming a hidebound financial services sector.

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Gaza Disengagement  
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15. (SBU) A range of GOI officials have told us that PM Sharon is committed to implementing his Gaza Disengagement plan on time ) at the latest. Fast-paced legislative movement reflects this commitment. On November 3, the Knesset approved the first reading of the Disengagement legislation. On November 15 the Knesset Finance Committee approved the transfer of NIS 35 million for the Disengagement Plan: NIS 30 million for prepayment of compensation to Settlers who agree to leave their homes, and NIS 5 million for the cost of the Justice Ministry to prepare Compensation ) Evacuation legislation. On November 16 the Disengagement Administration officially commenced its operations, with the inauguration of its website including information and forms regarding compensation calculations and maps showing re-settlement possibilities.

16. (SBU) The Israeli media estimates disengagement will cost more than NIS 5 billion (USD 1.1 billion). The Finance Ministry plans to apportion payment over two years in the 2005/2006 Budgets. For 2005, the MOF has proposed accommodating disengagement-related spending by raising the deficit target to 3.4% from the original 3%, as well as by increasing real expenditure growth above the 1% target. As these targets form a core element of Loan Guarantee Agreement economic conditionality, the MOF has requested USG views on the changes. Although the Israeli press has reported the GOI will request U.S. assistance to pay for at least a part of disengagement, no formal request has been made to date.

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The 2005 Budget ) Temporarily Tabled  
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17. (U) The GOI will likely begin 2005 without a new budget. Although PM Sharon had waited a number of months to submit the budget in the hope of finding the necessary votes, he finally decided that the cost of losing was less than not forcing a decision. In the end, only Sharon's own Likud party and United Torah Judaism supported the NIS 264.5 billion (approximately USD 60 billion) bill in its first reading on December 1. Sharon fired ministers from the Shinui party who voted against the budget, an action which reduced his coalition to a party of one and set the stage for ongoing coalition negotiations with the opposition Labor party, United Torah Judaism and Shas. Sharon has threatened to call early elections if he cannot build a coalition with Labor.

18. (SBU) According to contacts at the Ministry of Finance, Labor will make a big show of obtaining changes to the 2005 budget once it is in the coalition. In reality, these changes will probably center on a fairly modest increase in transfer payments to the elderly, which can be accommodated within the budgetary framework. Even if Labor achieves more significant budgetary changes, these will be paid for out of across-the-board reductions in ministerial budgets, not through additional spending, according to our Finance Ministry contacts. The result: a 2005 deficit that should not exceed 3.4% of GDP (disengagement expenses included).

19. (U) Assuming the budget does not pass before the end of the year, the Government will begin operating on a monthly appropriations based, per line item, on the lower of either the 2004 actual or 2005 proposed budgets. In accordance with Israeli law, if the Budget is not passed by March 31, 2005, the Government would fall, and new elections would be called in 90 days.

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